

Sustainability of Inflation in Japan hinges on Service Prices

30 June 2023

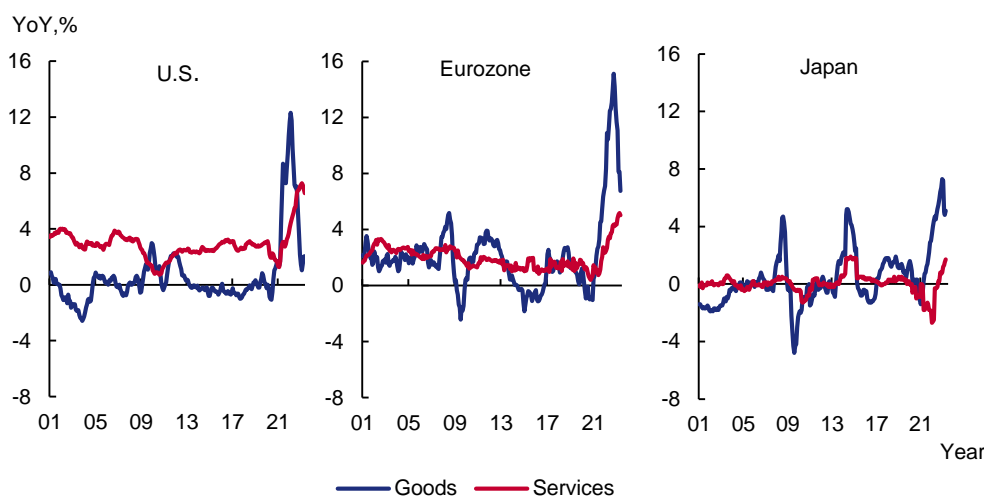
- ▶ Service prices, which are key to sustaining stable inflation, are rising in Japan.
- ▶ Wages, which are easily reflected in service prices, experienced a significant increase during the spring labour negotiations. However, the Bank of Japan remains cautious about the sustainability of inflation. It recognises the need for established corporate behaviour, including wage increases and appropriate price transfers, especially among small and medium-sized enterprises.
- ▶ The government plays a significant role in promoting labour market reforms and ensuring appropriate pricing by companies. The current inflation resulting from increased import costs is expected to progress towards a “positive cycle of wages and prices” with wage increases and changes in pricing behaviour.

The core consumer price index (Core CPI, which excludes fresh food) in Japan has been exceeding the Bank of Japan’s (BoJ) inflation target of 2% since April 2022. This trend is evident across various CPI categories, with approximately 84% of items showing a year-on-year increase, marking the highest proportion since 2001, as estimated by the BoJ. Additionally, a notable feature of recent inflation in Japan is the rise in service prices. While goods prices in Japan align somewhat with international commodity markets like the United States and Europe, service prices have mostly stayed near 0% since 2001, excluding the impact of the consumption tax rate increases in 2014 and 2019, and reductions in mobile communication fees in 2021 (Figure 1).



Yuko Iizuka, Economist

**Figure 1: CPI in U.S., Eurozone and Japan
-Goods and Services-**



**“Rising Service Prices
in Japan”**

Source: Refinitiv, Ministry of Internal Affairs and Communications
 Period: Monthly data from January 2001 to May 2023 for U.S. and Eurozone.
 Monthly data from January 2001 to April 2023 for Japan.
 Note: The data for U.S. includes Goods (excluding food and energy) and Services of CPI.
 The data for Eurozone includes Goods and Services of HICP and it shows EA-19 countries data.
 The data for Japan includes Goods (excluding fresh food) and Services of CPI.

The breakdown of service prices in Japan's CPI figure in April 2023 is as follows: public services (12.2% CPI weight) increased by 0.7% year-on-year, and general services (37.4% CPI weight) increased by 2.0%. While the growth in public services, which include regulated prices, is limited, increase in general services is exceeding 2% for the first time since 1995, although this excludes the impact of the consumption tax rate increases. Prices for food service have risen by 7.3%, housekeeping prices have risen by 3.6%, and communication/education and entertainment services have risen by 2.9%. The rise in food service and housekeeping (e.g. repairs and cleaning) is partly due to increased cost of raw materials, while an 8.1% year-on-year rise in accommodation charges in education and entertainment reflects higher labour costs due to labour shortages.

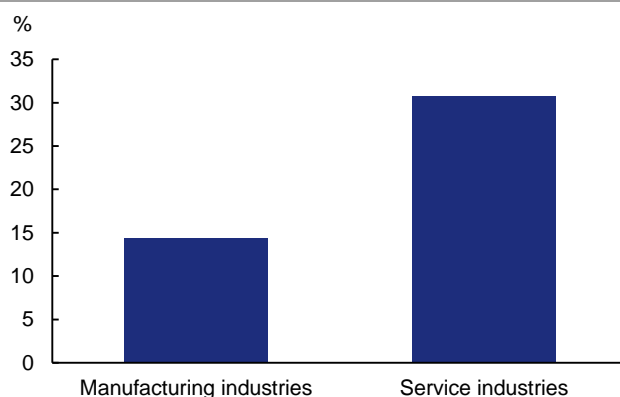
Former BoJ Governor Haruhiko Kuroda stated in a June 2022 speech that achieving an annual inflation rate of about 2% in Japan would require a constant contribution of about 2% from service prices, and cyclical fluctuations in goods prices around that level.

Since assuming office in April 2023, Governor Toshihiko Ueda added the phrase "accompanied by wage increases" in the forward guidance to achieve the BoJ's target of sustained and stable achievement of 2% inflation.

The cost of manufacturing goods is influenced by factors such as the high proportion of raw material procurement and some imports, making them susceptible to changes in commodity markets and exchange rates. On the other hand, services tend to have a higher proportion of labour costs in total expenses. According to calculations based on corporate statistics published by the Ministry of Finance, Japan, labour costs account for about twice the proportion of total expenses in service industries compared to manufacturing industries (Figure 2).

"Sustainable and stable inflation requires sustained increases in service prices"

Figure 2: Proportion of labour costs in total expenses



Source: Ministry of Finance, Japan

Period: FY2021

Note: The labour cost includes the total of director salaries and bonuses, employee salaries and bonuses and welfare expense.

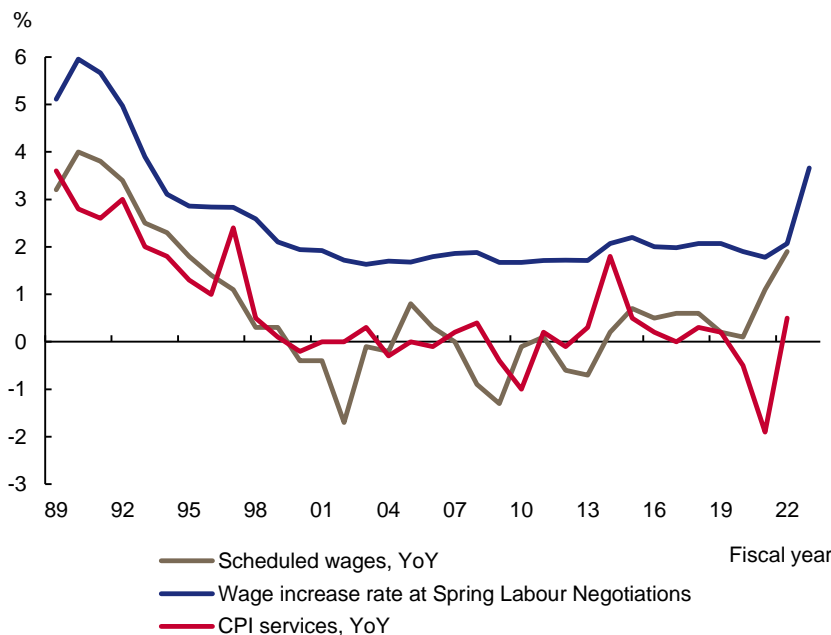
The total expense includes the total of COGS and SG&A.

It is believed that service prices more readily reflect wage trends. Furthermore, wage increases are crucial for sustaining continuous inflation, as they help maintain consumers' real purchasing power and increase tolerance for price increases.

This year's spring labour negotiations resulted in high wage increases due to the demand to maintain real purchasing power of households amidst rising prices and the need to secure headcounts at companies experiencing labour shortages. According to calculations by the Japanese Trade Union Confederation, Rengo, the wage increase rate reached 3.7% (as of 1 June, including regular raises and base pay increases), marking the highest growth since 1993 (Figure 3). While the growth in scheduled wages had already increased in the previous fiscal year, it is expected to remain at a high level in the current fiscal year, leading to steady real purchasing power.

“Sharp Rise in Wage Increases during the Spring Labour Negotiations”

Figure 3: Wage increases during the Spring Labour Negotiations, scheduled wages and CPI services



Source: Ministry of Internal Affairs and Communications, Ministry of Health, Labour and Welfare and Rengo.

Period: From FY1989 to FY2023. The data for the scheduled wages and CPI services is from FY1989 to FY2022. The data of Spring Labour Negotiations is the final aggregated figures as of the end of June 2023.

Note: The subjects of the investigation for the scheduled wages are companies which have more than 30 employees (total of surveyed industries). The data of wage increase rate was aggregated by Rengo.

The data of 2023 was aggregated on 1 June 2023.

CPI service figures were affected by the consumption tax rate increases, free preschool education and childcare, and reductions in mobile communication fees during the following periods.

- The consumption tax rate increases : FY1989, FY1997, FY2014, from October 2019 to September 2020
- Free preschool education and childcare : From October 2019 to September 2020
- Reductions in mobile communication fees : FY2021

The BoJ published an academic research report on the impact of cost increases on consumer prices by cost factors, examining pass-through of cost increases to consumers, in May 2023 on its website, although not an official view. The report states that while the impact of changes in corporate prices such as raw materials and exchange rates on consumer prices is often temporary, wage changes themselves exhibit high inertia, suggesting a sustained influence of wage increases on prices.

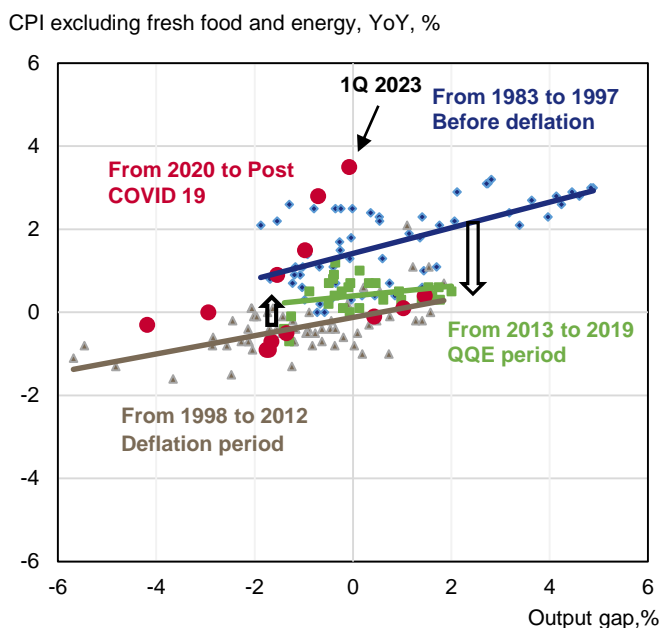
From this analysis, it can be said that wage increases are one of the keys to sustainable and stable inflation. In next year's spring labour negotiations, we expect high wage increase rates to continue due to the response to the ongoing price increases and the objective of securing personnel amidst labour shortages.

BoJ Governor Ueda acknowledges the high wage increase rate during this year's spring labour negotiations and the strong trend in current price increases. However, he recognises the high uncertainty regarding achieving the price target. The movement of wage increases, including their spread to small and medium-sized enterprises, needs to be observed to determine if it will continue and become firmly established.

Additionally, Ueda mentioned the need to improve the output gap using the Phillips curve, the relationship between inflation and the output gap, and raise the expected inflation rate, shifting the curve upward (Figure 4). It is recognised that changes in corporate behaviour, including wage increases and appropriate price increases, are necessary for the sustained and stable achievement of the price stability target. In fact, in the April 2023 BoJ policy meeting, participants highlighted the importance of labour market reforms such as business model transformation and job transition.

**“The BoJ remains cautious
about the sustainability
of price increases”**

Figure 4: Phillips curve in Japan



Source: Ministry of Internal Affairs and Communications, BoJ and Nikkei NEEDS - FinancialQUEST

Period: Quarterly data from 3Q 1983 to 1Q 2023.

Note: Output gap is estimates of the BoJ.

The output gap shows 2 quarters preceding.

Impacts from the consumption tax rate increases after 2014, etc. were eliminated for CPI calculation.

The lines on the chart above are trend lines.

The government plays a significant role in promoting movements towards the positive cycle of wage and price increases, such as appropriate price transfers by companies and labour market fluidity.

The government conducts regular surveys to assess whether small and medium-sized enterprises are adequately transferring the increases in material costs and labour expenses to transaction prices with their client companies. For companies that do not respond to price negotiations or engage in unfair pricing, the government has strengthened guidance and advice, and in February of this year, it actually publicly disclosed the names of such companies.

The subtitle of the “Basic Policy for Economic and Fiscal Management and Reform”, known as the “Bold Policy”, approved by the cabinet in June is “Expanding Investment for the Future and Achieving Structural Wage Increases.” It incorporates measures such as labour market reforms, including the establishment of systems that facilitates job transitions, and the consideration of tax systems that enable wage increases even at loss making companies.

It is expected that the current price increases driven by increased import costs will progress toward a “positive cycle of wage and price increases” with wage increases and appropriate price transfers.

“Government policies to support corporate pricing behaviour”

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